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LEASE STRIPPING TRANSACTIONS
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ISSUE

Whether multiple-party transactions where one party realizes rental income and other income from a contract and another party reports deductions related to that income in a lease stripping transaction must be respected for federal income tax purposes?

CONCLUSION

The theories upon which the Service might successfully challenge lease stripping transactions must be determined on a case-by-case basis depending on the specific facts and circumstances of each case. In Notice 95-53, 1995-2 C.B. 334, the Service discusses "lease strips" and the tax consequences of these transactions. In addition to the code sections and theories discussed herein, the Service announced that it may apply the following Code sections and theories to lease strips: Sections 269, 382, 701, or 704, and the regulations thereunder and the assignment of income theory. Other theories applicable to lease strips include the Partnership Anti-abuse rule found in Treas. Reg. 1.701-2(a)-(d). Some of the theories are fact-intensive. To assist in adequately developing the facts, early coordination with the Leasing Issue Specialist is encouraged and advice of Counsel should be sought on which theories to pursue and which facts to develop in a particular case.

FACTS

A, a corporation, owns depreciable equipment subject to pre-existing user leases. A and B, a thinly capitalized partnership, engage in a sale-leaseback of the equipment. B issues a note to A for the equipment. The payments due under the terms of B's note approximate the rental payments due under the lease. A retains the option to buy the equipment back at the end of the lease term, and also retains all risks associated with the leased equipment. The residual value of the equipment at the end of the lease term is minimal.

B has a majority 98 percent partner, C, who is exempt from United States taxation. B subsequently sells the rent receivables from A to a bank for cash, thereby accelerating the income due under the lease. B allocates to C, the tax-exempt partner, C's respective share of the accelerated income. B uses the cash to pay off its note to A.[1]

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[1] If B does not pay off the note to A, or if B transfers property, rights, or obligations other than the equipment to D, the section 351 analysis contained in this paper may not be relied

D, a corporation, is a subsidiary of E, also a corporation. E is the parent of a consolidated group which includes D. B contributes the equipment to D in exchange for preferred D stock in a purported I.R.C. § 351 transaction.[2] At the same time, E transfers property to D in exchange for additional D common stock. The amount of the property E transfers to D is sufficient for E to count as a transferor in the purported section 351 transaction. D receives depreciation deductions for the depreciable equipment; the deductions are used by the E consolidated group. Assume for the purposes of this paper that all years are open.

DISCUSSION

1. SHAM/LACK OF ECONOMIC SUBSTANCE THEORIES

a. Sham Transactions Disregarded

When a transaction is treated as a sham, the form of the transaction is disregarded in determining the proper tax treatment of the parties to the transaction. A transaction that is entered into primarily to reduce taxes and that has no economic or commercial objective to support it is a sham and is without effect for federal income tax purposes. Frank Lyon Co. v. United States, 435 U.S. 561 (1978); Rice's Toyota World Inc. v. Commissioner, 752 F.2d 89, 92 (4th Cir. 1985).

The sham approach hinges on all of the facts and circumstances surrounding the transactions involved in a lease stripping transaction. No single factor will be determinative. Whether a court will respect the taxpayer's characterization of the transaction depends on whether there is a bona fide transaction with economic substance, compelled or encouraged by business or regulatory realities, imbued with tax-independent considerations, and not shaped primarily by tax avoidance features that have meaningless labels attached. See Frank Lyon Co. v. United States, 435 U.S. 561 (1978); ACM Partnership v. Commissioner, 157 F.3d 231 (3rd Cir. 1998), aff'g in relevant part T.C. Memo. 1997-115; Casebeer v. Commissioner, 909 F.2d 1360 (9th Cir. 1990); Rice's Toyota World, Inc. v. Commissioner, 752 F.2d 89 (4th Cir. 1985), aff'g in part 81 T.C. 184 (1983); Compaq v. Commissioner, 113 T.C. 363 (1999); UPS of Am. v. Commissioner, T.C. Memo. 1999-268; Winn-Dixie v. Commissioner, 113 T.C. 254 (1999).

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upon to determine the gain or loss recognition and basis consequences of the underlying transactions.

2 Other lease strips involve contributions of the partnership interest by the tax-neutral partner to a corporation in a purported section 351 transaction. Also, B could engage in a second sale-leaseback and thereafter transfer certain property and rental obligations to a corporation. In that situation, the corporation subsequently takes a deduction for rental payments. Such a transaction involves further basis calculations not addressed by this paper.

In ACM Partnership, the Tax Court found that the taxpayer desired to take advantage of a loss that was not economically inherent in the object of the sale, but which the taxpayer created artificially through the manipulation and abuse of the tax laws. T.C. Memo. 1997-115. The Tax Court further stated that the tax law requires that the intended transactions have economic substance separate and distinct from economic benefit achieved solely by tax reduction. It held that the transactions lacked economic substance and, therefore, the taxpayer was not entitled to the claimed deductions. Id. The opinion demonstrates that the Tax Court will disregard a series of otherwise legitimate transactions, where the Service is able to show that the facts, when viewed as a whole, have no economic substance.

The lease stripping transactions outlined above, taken as a whole, have no business purpose independent of tax considerations. As a result, the consolidated group is not entitled to any deductions relating to the transaction.

b. Sham the Partnership/Partners

Sham principles may also be applied to the partnership and the partners. In order for a federal tax law partnership to exist, the parties must, in good faith and with a business purpose, intend to join together in the present conduct of an enterprise and share in the profits or losses of the enterprise. The entity's status under state law is not determinative for federal income tax purposes. Commissioner v. Tower, 327 U.S. 280, 287 (1946); Luna v. Commissioner, 42 T.C. 1067, 1077 (1964). The existence of a valid partnership depends on all of the facts, including the agreement of the parties, the conduct of the parties in execution of its provisions, their statements, the testimony of disinterested persons, the relationship of the parties, their respective abilities and capital contributions, the actual control of income and the purposes for which it is used, and any other facts shedding light on the parties' true intent. The analysis of these facts shows whether the parties in good faith and action, with a business purpose, intended to join together for the present conduct of an undertaking or enterprise. Commissioner v. Culbertson, 337 U.S. 733, 742 (1949); ASA Investerings Partnership v. Commissioner, 201 F.3d 505 (D.C. Cir. 2000), aff'g T.C. Memo. 1998-305.

In ASA Investerings, the Tax Court first disregarded several parties as mere agents in determining whether the parties had formed a valid partnership. T.C. Memo. 1998-305. In reaching its conclusion that the remaining parties did not intend to join together in the present conduct of an enterprise, the court found that the parties had divergent business goals.

The Tax Court's opinion was affirmed by the Court of Appeals for the District of Columbia. ASA Investerings Partnership v. Commissioner, 201 F.3d 505 (D.C. Cir. 2000). Although the appellate court wrote that parties with different business goals are not precluded from having the intent required to form a partnership, the court affirmed the Tax Court's holding that the arrangement between the parties was not a valid partnership, in part because "[a] partner whose risks are all insured at the expense of another partner hardly fits within the traditional notion of partnership." Id. at 515. The appellate court rejected the taxpayer's argument that the test for whether a partnership is valid differs from the test for whether a transaction's form should be respected, writing that "whether the 'sham' be in the entity or the transaction . . . the absence of a nontax business purpose is fatal." Id. at 512.

The participation of B and its partners in the lease stripping transactions outlined above, taken as a whole, has no business purpose independent of tax considerations and should be disregarded. Once one ignores B, all that is left is a basic sale-leaseback transaction between D and A. Also in this situation, the participation of B should be disregarded because B acted on behalf of E and its activities were designed solely to create deductions for the E consolidated group. Under this alternative theory, the E consolidated group may still be able to take deductions; however, the group will have to take into income the accelerated income from the bank.

c. Step Transaction

The step transaction doctrine is a rule of substance over form that treats a series of formally separate but related steps as a single transaction if the steps are in substance integrated, interdependent, and focused toward a particular result. Penrod v. Commissioner, 88 T.C. 1415, 1428 (1987). Because the Tax Court has applied the step transaction doctrine even where it did not find a sham transaction, this doctrine should be considered in addition to the economic substance argument discussed above. See Packard v. Commissioner, 85 T.C. 397 (1985).

In characterizing the appropriate tax treatment of the end result, the doctrine combines steps; however it does not create new steps, or recharacterize the actual transactions into hypothetical ones. Greene v. United States, 13 F.3d 577, 583 (2nd Cir. 1994); Esmark v. Commissioner, 90 T.C. 171, 195-200 (1988), aff'd per curiam, 886 F.2d 1318 (7th Cir. 1989).

Some lease stripping transactions may lend themselves to being collapsed. If so, the question is whether the transitory steps added anything of substance or were nothing more than intermediate devices used to enable the subsidiary corporation to acquire the lease property stripped of its future income, leaving the remaining rental expense and depreciation deductions to be used to offset other income. See Helvering v. Alabama Asphaltic Limestone Co., 315 U.S. 179, 184-185 (1942).

Courts have developed three tests to determine when separate steps should be integrated. The most limited is the "binding commitment" test. If, when the first transaction was entered into, there was a binding commitment to undertake the later transaction, the transactions are aggregated. Commissioner v. Gordon, 391 U.S. 83 (1968); Penrod, 88 T.C. at 1429. If, however, there was a moment in the series of transactions during which the parties were not under a binding obligation, the steps cannot be integrated using the binding commitment test, regardless of the parties' intent.

Under the "end result" test, if a series of formally separate steps are prearranged parts of a single transaction intended from the outset to achieve the final result, the transactions are combined. Penrod, 88 T.C. at 1429. This test relies on the parties' intent at the time of the transactions, which can be derived from the actions surrounding the transactions. For example, a short time interval suggests the intervening transactions were transitory and tax-motivated. A short time interval, however, is not dispositive.

A third test is the "interdependence" test, which considers whether the steps are so interdependent that the legal relations created by one transaction would have been fruitless without completing the series of transactions. Greene, 13 F.3d at 584; Penrod, 88 T.C. at 1430. One way to show interdependence is to show that certain steps would not have been taken in the absence of the other steps. Steps generally have independent significance if they were undertaken for valid business reasons.

In this transaction, the nature of B and C's involvement may support the conclusion that steps involving B and C should be eliminated from the transaction. In this event, D could be required to recognize the accelerated income arising from the purported sale of the rent stream to the bank. Therefore, through the consolidated return, E would recognize the income, and thereby match the income with the deductions.

2. SECTION 351[3]

Section 351(a) provides that no gain or loss shall be recognized if property is transferred to a corporation by one or more persons solely in exchange for stock in such corporation and immediately after the exchange such person or persons are in control of the corporation. For purposes of section 351, control is defined as ownership of at least 80 percent of the total combined voting power of all classes entitled to vote and at least 80 percent of the total number of shares of all other classes of stock of the transferee corporation. Sections 351(a) and 368(c). The ownership interests of all transferors participating in a single transaction are aggregated to determine whether the control test is met. Generally, to determine control, a group of transferors may include all of the transferee stock owned by each transferor participating in the transaction, not just the shares the transferors receive in the current transaction. But see Treas. Reg. § 1.351-1(a)(1)(ii) and section 3.07 of Rev. Proc. 77-37, 1977-2 C.B. 568, 570, which negate transfers by a transferor that previously owned transferee stock if the value of the new stock issued to that transferor is relatively small compared to the value of the old stock owned by that transferor and the primary purpose of the transfer by that transferor was to qualify other transferors for section 351 treatment.

Section 358(a)(1), in relevant part, provides that in an exchange to which section 351 applies and in which the transferor receives only transferee stock, the basis of property permitted to

[3] The arguments contained in this portion of the paper assume that the existence of B could not be ignored under a sham transaction theory. The sham transaction theory and the section 351 alternative arguments are mutually exclusive.

be received (i.e., the stock of the transferee corporation received by the transferor) under such section without the recognition of gain or loss shall be the same as that of the property exchanged.

Section 362 (a), in relevant part, provides that in a section 351 transaction, in which the transferor receives only transferee stock, the (transferee) corporation's basis in the property acquired in the transaction will be the same as it would be in the hands of the transferor, increased in the amount of gain recognized to the transferor on such transfer.

Courts have indicated there is a business purpose requirement in section 351. See Hempt Bros., Inc. v. United States, 490 F.2d 1172, 1178 (3d Cir. 1974), cert. denied, 419 U.S. 826 (1974); Stewart v. Commissioner, 714 F.2d 977, 992 (9th Cir. 1983). Perhaps the most thorough judicial exploration of the business purpose doctrine in section 351 is in Caruth v. United States, 688 F. Supp. 1129, 1138-41 (N.D. Tex. 1987), aff'd, 865 F.2d 644 (5th Cir. 1989). Generally, section 351 will apply to a transaction if the taxpayer has any valid business purpose for the transaction other than tax savings. See Stewart v. Commissioner, 714 F.2d 977, 991 (9th Cir. 1983); Rev. Rul. 60-331, 1960-2 C.B. 189, 191. Whether a valid business purpose underlies a lease strip transaction requires intensive factual development of the transfers.

If the transfer does not qualify under section 351, then it would be treated as a taxable exchange under section 1001.[4] D would still recognize no gain or loss on the transaction under section 1032,[5] however D would determine its basis in the property it receives under section 1012. Under Treas. Reg. § 1.1012-1(a), D takes a basis in the equipment equal to the fair market value of the stock D distributes in the exchange. The fair market value of the preferred stock D distributes in the exchange is typically less than B's basis in the equipment. Consequently, D, and through the consolidated return E, would not be able to take depreciation deductions in the claimed amounts. Depreciation deductions would instead be calculated based on D's section 1012 basis in the equipment. As a taxable exchange under section 1001, B would recognize gain or loss on the exchange and determine its basis in the D preferred stock it receives under section 1012.

If, after considering all of the issues addressed in this paper, the purported section 351 transfer is respected as such and D is allowed depreciation deductions with respect to the equipment it received from B, some or all of the depreciation deductions may be subject to the separate return limitation year ("SRLY") limitation on built-in losses or built-in deductions. The threshold amount required for a built-in loss or built-in deduction to be subject to the SRLY limitation, the mechanisms for determining whether a built-in loss or built-in deduction exists, and the amount of the SRLY limitation vary depending on several factors. The factors include the date of the transfer, the tax year of the depreciation deduction, the difference

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[4] If the transaction is a sale under section 1001, B may be able to recognize a loss at the time of the sale.

[5] Section 1032 provides that no gain or loss shall be recognized to a corporation on the receipt of money or other property in exchange for stock of such corporation.

between the fair market value and the adjusted basis of the assets transferred from B to D, and certain elections made by the E consolidated group. See generally Treas. Reg. § 1.1502-15 (particularly paragraph (b)(2)(ii)), 1.1502-15A (particularly paragraph (a)(2)), and 1.1502-15T(b)(2)(i)). For years to which Treas. Reg. § 1.1502-15A applies, the organizational status of the transferor also is a relevant factor.

2. BENEFITS AND BURDENS OF OWNERSHIP/ SALE V. FINANCING

Whether a transaction represents a sale for federal income tax purposes depends on the economic substance of the underlying transaction. Levy v. Commissioner, 91 T.C. 838, 859-62 (1988). The issue is whether the buyer of the equipment acquired the benefits and burdens of ownership. This is a question of fact as evidenced by the written agreements read in light of the attendant facts and circumstances.

In determining whether a sale of the equipment should be respected, the relevant factors are: (1) the investor's equity interest in the property as a percent of the purchase price; (2) renewal or purchase options at the end of the lease term based on fair market value of the equipment; (3) whether the useful life of the property exceeded the lease term; (4) whether the projected residual value of the equipment plus the cash-flow generated by the rental of the equipment allowed the investors to recoup at least their initial cash investments; (5) whether at some point a turnaround was reached whereby depreciation and interest deductions were less than income received from the lease; (6) whether the net tax savings for the investors was less than their initial cash investment; (7) whether there was the potential for realizing a profit or loss on the sale or release of the equipment; (8) whether the documentation was consistent with the substance of the transactions; and (9) whether the parties acted in a manner consistent with the purported sale. Levy, 91 T.C. at 860; see also Grodt & McKay Realty v. Commissioner, 77 T.C. 1221, 1238 (1981). A transaction may be a financing arrangement if repayment of the debt is relatively certain, and the putative buyer has little risk. Mapco, Inc. v. United States, 556 F.2d 1107 (Ct. Cl. 1977). Assuming the factors above indicate that the transaction between A and B was a financing and not a sale, then the partnership, B, would not be the owner of the equipment, and thus could not transfer the equipment along with depreciation or other related deductions to D for the benefit of the E consolidated group.

3. SECTION 482

Under section 482, the Service may allocate income or deductions between entities owned or controlled by the same interests in order to prevent the evasion of taxes or clearly to reflect income. Because lease stripping transactions are often effected by a sequence of transactions between entities with no overlapping ownership interests, section 482 may only apply to such transactions that are carried out pursuant to a common design that was intended to effect an arbitrary shifting of income and deductions. Where this can be shown, the parties may be treated for purposes of the transaction as controlled by the same interests under section 482. Consequently, under such conditions, the participants would be part of the same controlled group, evidenced by their acting in concert with a common goal to shift deductions to the E consolidated group and income to C, a person or entity exempt from U.S. taxation.

A section 482 analysis of control does not focus rigidly on equity ownership. Rather it focuses on the ability of a person or an entity to direct the actions of another entity. The control may be direct or indirect, regardless of whether it is legally enforceable, and regardless of how it is exercised or exercisable. Treas. Reg. § 1.482-1(a)(3), 1958-1 C.B. 218; Treas. Reg. § 1.482-1T(g)(4), 1993-1 C.B. 90; Treas. Reg. § 1.482-1(i)(4), 1994-2 C.B. 93. It is the reality of control that is determinative. Treas. Reg. § 1.482-1(i)(4) (1994).

A presumption of control arises if income or deductions have been arbitrarily shifted, as a result of the actions of two or more persons acting in concert with a common goal or purpose. Treas. Reg. § 1.482-1(i)(4)(1994). See Dallas Ceramic Co. v. Commissioner, 598 F.2d 1382, 1389 (5th Cir. 1979). Under the facts here, the Service's burden of establishing the shifting of income and deductions may be met by 1) the stripping of income from the leases and the allocation of that income to C (B's 98 percent partner who is effectively not subject to U.S. tax) and 2) by D's reporting of the depreciation deductions relating to the income (and, through the consolidated return, by E).

In determining whether income and deductions have been arbitrarily shifted and whether different persons were acting in concert pursuant to a common goal, the following nonexclusive factors should be considered: 1) whether the lease stripping transaction was a registered tax shelter; 2) whether the parties to the lease stripping transaction acted pursuant to a common plan that was designed to provide certain tax benefits to the taxpayer; 3) whether the individual steps that constitute the entire lease stripping transaction make little economic and business sense from the perspective of a "hard-headed" business person; 4) the tax and non-tax benefits that each party to the lease stripping transaction stood to gain by engaging in the transaction, including whether a participant's benefits were merely compensation for performing its pre-designed role; 5) the ability of an entity to perform its obligations under the lease arrangement(s) with its own employees; and 6) an absence of any business activity by one of the parties to the lease stripping transaction, other than the lease stripping transaction at issue.

Once control is established by demonstrating that there was a common plan to shift arbitrarily income and deductions, it must be determined whether the control was exercised by the same interests. Although the phrase "same interests" is not defined in the section 482 regulations, case law as well as the legislative history of section 482 provide guidance. The phrase "same interests" includes different persons with a common plan to shift income and deductions. Brittingham v. Commmissioner, 598 F.2d 1375, 1379 (5th Cir. 1979); South Texas Rice Warehouse Co. v. Commissioner, 366 F.2d 890, 894-5 (5th Cir. 1966), aff'g 43 T.C. 540 (1965), cert. denied, 386 U.S. 1016 (1967). Thus, central to the demonstration of "control" by the "same interests" is the establishment of a common design to shift income and deductions. See Hall, 32 T.C. at 409-10. Section 482 should not be applied to entities with no overlapping equity interests, unless the Service can establish this common design.

Section 482 should be considered in conjunction with the other theories addressed in this paper, such as the sham and step transaction doctrines, because section 482 may apply regardless of whether the transaction is a sham.

Once control by the same interests is established, section 482 may be applied under three alternative theories. First, the transaction can be disregarded under the economic substance standards of section 482, which allows the Service, where the economic substance of a transaction is inconsistent with the parties' purported characterization, to disregard the contractual terms underlying the transaction and treat the transaction consistent with its economic substance. See B. Forman v. Commissioner, 453 F.2d 1144, 1160-61 (2d Cir. 1972), rev'ing in relevant part 54 T.C. 912 (1970), cert. denied, 407 U.S. 934 (1972); Medieval Attractions N.V. v. Commissioner, T.C. Memo. 1996-455. The regulations expand upon the case law relating to economic substance and sham doctrines, and focus in particular on certain factors such as the parties' actual conduct, the economic risks purportedly transferred, and whether, from a business perspective, the transaction makes objective business sense and would have been entered into by a "hard-headed business [person]." See B. Forman, 453 F.2d at 1160-61; Treas. Reg. § 1.482-1(d)(1) (1968), 1.482-1T(d)(1) (1993), 1.482-1(d)(3)(ii)(B) (1994). If a transaction lacks economic substance under section 482, the Service may disallow deductions arising from the transaction. Here, D would be treated as not having acquired B's equipment interest, and depreciation deductions reported by D would be allocated to B.

Second, the Service may apply section 482 to nonrecognition transactions where property was contributed for tax avoidance purposes. For example, section 482 may allocate income and deductions arising from an entity's disposition of built-in-loss property, which it acquired in a nonrecognition transaction, to the shareholder (or partner) that contributed it in the transaction. See Treas. Reg. § 1.482-1(d)(5) (1968), 1.482-1T(d)(1)(iii) (1993), 1.482-1(f)(1)(iii) (1994); National Securities Corp. v. Commissioner, 137 F.2d 600 (3rd Cir. 1943), cert. denied, 320 U.S. 794 (1943). In lease stripping transactions, this analysis may apply by likening the contribution of property (in a purported section 351 nonrecognition transaction) after the income has been stripped off to a contribution of built-in-loss property. Thus, B's transfer of the equipment interest to D (from which the right to future taxable streams of rental income had already been sold) is in substance a contribution of built-in loss property by B to D, and the Service could allocate D's deductions to B.

The third theory under section 482 relates to the allocation of income and deductions in order to clearly reflect income or prevent the evasion of taxes. It focuses on the distortions in taxable income caused by the separation of income from deductions. The separation of income from deductions in lease stripping transactions does not clearly reflect income because (1) it artificially separates the rental income from the associated deductions by accelerating the income in the hands of an entity not subject to the U.S. tax, and (2) the entity subject to U.S. tax receives the deductions but not the rental income associated with the deductions. See Notice 95-53. The Service may prevent this artificial shifting of income and deductions by allocating either the rental deductions from the taxpayer to the tax-exempt entity, or the rental income, or the gain from the sale of a rent receivable, from the tax-exempt entity to the taxpayer. See, e.g., Charles Town, Inc. v. Commissioner, 372 F.2d 415 (4th Cir. 1967), cert. denied, 389 U.S. 841 (1967); Rooney v. United States, 305 F.2d 681 (9th Cir. 1962); Central Cuba Sugar Co. v. Commissioner, 198 F.2d 214 (2d Cir. 1951), cert. denied, 344 U.S. 874 (1952).

5. SECTION 446(b)

Under section 446(b), the Service has broad authority to determine whether a method of accounting for a particular item of income or expense clearly reflects income. See Thor Power Tool Co. v. Commissioner, 439 U.S. 522 (1979). If a taxpayer's method of accounting for a particular item of income or expense does not clearly reflect income, the Service can compute the taxpayer's income using a method that does. See RCA Corp. v. United States, 664 F.2d 881, 886 (2nd Cir. 1981), cert. denied, 457 U.S. 1133 (1982). Clear reflection of income can require deferred or up-front recognition of income, depending on the factual situation. See section 467(f); Commissioner v. P.G. Lake, 356 U.S. 260 (1958).

Moreover, an assignment of future rents is unlike the advance payments at issue in Schlude v. Commissioner, 371 U.S. 128 (1963) and American Automobile Association v. United States, 367 U.S. 687 (1961). In those cases, the taxpayers received advance payments for services whose time or certainty of performance could not be predicted.

The Service will not rely solely on section 446(b) in any lease stripping case. For example, if, pursuant to section 482, lease income is reallocated to the taxpayer who claims deductions generated by the leased property, section 446(b) might be the basis for recognizing that income as it is earned under the lease, rather than at the time the lease stream is sold. Thus, under our facts, D would recognize income as it is earned on the leases.

6. PROPOSED TREASURY REGULATION § 1.7701(L)-2

Proposed Treas. Reg. § 1.7701(l)-2 provides rules for the treatment of obligation shifting transactions. The regulations are intended to produce tax results that conform to the economic substance of lease stripping transactions by requiring the person that is treated for federal income tax purposes as the owner of the property to recognize the income that is produced during the person's period of ownership. To achieve this result, the proposed regulations recharacterize transactions in which a transferee assumes obligations under an existing lease or similar agreement and the transferor or any other party has already received or retains the right to receive amounts allocable to periods after the transfer. The proposed regulations affect the tax consequences of the transferee/assuming party and the transferor/property provider. The proposed effective date would apply to stripping transactions entered into or undertaken on or after October 13, 1995.

Under these regulations, A is a property user because A has the right to use the property under the lease with B. B is a property provider as to its obligations under the lease to make the property available to A. D is an assuming party because D acquired B's obligations under the lease with A to make the equipment available. The transaction is an obligation-shifting transaction because D is an assuming party and C has already received income allocable to periods after the transaction (i.e., the allocations of income from the sale of future lease receivables). E would be treated as recognizing the income. Thus, D is treated as assuming the partnership's obligations under the lease.

Under the regulations, the transaction would be characterized as follows: D is treated as acquiring the right to the amounts allocable to the rental periods after the obligation-shifting transaction. Thus D, and through the consolidated return, E, would recognize the income from the sale of the receivables to the bank.